Public Comments
for
Energy Tax Reform Working Group
U.S. House Committee on Ways and Means

Oklahoma Independent Petroleum Association
500 N.E. 4th St., Suite 200
Oklahoma City, OK 73104

Public Comments
for the
Energy Tax Reform Working Group
U.S. House Committee on Ways and Means
by the
Oklahoma Independent Petroleum Association

Please accept the following comments as part of the Energy Tax Reform Working Group's examination of U.S. energy tax policies and their role in job creation, economic expansion, state and federal revenue growth, and energy security.

The Oklahoma Independent Petroleum Association (OIPA) appreciates the challenges of comprehensive tax reform and understands that in addition to providing an opportunity to eliminate outdated, inequitable, or unworkable policies, tax reform also presents a chance to reaffirm policymakers' commitment to provisions that are succeeding in meeting national goals.

With more than 2,500 members, OIPA is among the nation's largest and most active state-based trade associations for independent producers of crude oil and natural gas and the service companies which support them. Unlike integrated major oil companies, OIPA's independent producers have no refining or retail marketing operations.

Policymakers must understand that the greater U.S. oil and gas industry is neither monolithic nor homogeneous. Tax treatments important to, or available to, major integrated companies are not used by smaller independent producers and marginal well operators and vice versa.

While OIPA members apply several of the energy tax treatments identified by the Joint Committee on Taxation for discussion, the OIPA will limit its comments to two oil and gas tax treatments independent producers most frequently identify as critical to their day-to-day operations:

- the ability to deduct ordinary and necessary business expenses in the year they occur (so-called intangible drilling costs), and;
- the ability to depreciate mineral assets as they decline (percentage depletion).

These existing rules are appropriate tax policies that have had a dramatic positive impact on U.S. energy production and the economy.

There are roughly 18,000 independent producers operating in 32 states. While some are larger and well known, the average independent producer employs 11 full-time and three part-time employees. He or she has been in business for 26 years on average. [1]

Clearly, the average independent producer is not "Big Oil."

Yet independent producers drill approximately 95 percent of all U.S. wells and account for 68 percent of total U.S. production – roughly 82 percent of U.S. natural gas production and more than 54 percent of domestic oil production.

Just onshore here in America, independents are responsible for:

- over 3 percent of the total U.S. workforce;
- more than 4 million American jobs;
- more than $579 billion in total economic activity;
- 4 percent of U.S. GDP;[2]

In 2010, independent producers' employees paid $30.7 billion in income, sales, and excise taxes. Their combined total federal, state, and local taxes, royalties and rents were $69.1 billion. Their ecosystem of direct, indirect and induced jobs generated $131 billion for federal and state coffers.[3]

Every $1 million of upstream capital expenditure by independent producers results in $1.1 million in total taxes, $5.1 million in overall contribution to U.S. GDP, six direct jobs, and 33 total upstream jobs.[4]

Speaking specifically about Oklahoma, the oil and gas industry is our lifeblood. Our industry is responsible for one out of every three dollars in gross state product, one out of every five dollars in personal income, and represents one out of every six jobs in our state. Since 2009, our industry has added nearly12, 000 jobs with the average compensation in our industry being more than $113,000 per job.

However, U.S. job creation is in no way limited to America's traditional oil patch. Federal tax policies that encourage producers to take risks in capital intensive exploration projects have spurred new onshore oil and gas investment in local economies from Appalachia and the Rust Belt through the Great Plains and into the West.

If federal policymakers do not undermine its potential, the U.S. energy renaissance will continue to dramatically improve lives and afford state and local governments the ability to improve citizen services.

IHS Global Insight predicts that U.S. jobs attributed specifically to unconventional oil and gas exploration will grow from 1.7 million in 2012 to 3.5 million by 2035 with many of those jobs in industries the general public does not typically associate with the oil and gas business – everything from automobile sales and steel manufacturing to agriculture and retail.

Unconventional activity alone contributed an estimated $62 billion in federal, state and local tax receipts in 2012. By 2020 total government revenue attributed to unconventional oil and gas activity will grow to just over $111 billion. On a cumulative basis that is more than $2.5 trillion in tax revenue between 2012 and 2035.[5]

When midstream and downstream factors are considered, America's oil and gas industry supports 9.2 million U.S. jobs and 7.7 percent of the nation's GDP according to the American Petroleum Institute (API). The industry pays $86 million in federal rents, royalties, bonus payments and income tax payments daily and has an effective tax rate of 44.3 percent.

America's recent economic recession would have been deeper and more painful without independent producers' commitment to high-skilled workers, good-paying blue-collar jobs, and American energy. The industry continues to lead the nation out of its economic doldrums and provides a foundation upon which other domestic industries from coast to coast are building.

Thanks to technological breakthroughs in horizontal drilling and hydraulic fracturing and appropriate tax treatments that encourage producers to risk private capital to find and produce new resources, America now imports less than 49 percent of its oil, down from 60 percent a few short years ago.

A recent Harris Interactive poll conducted for the Domestic Energy Producers Alliance (DEPA) shows that 93 percent of Americans believe energy independence is an important policy goal for the United States. Approximately 89 percent of Americans say energy independence will improve national security. We are on the way to achieving this goal.

According to the U.S. Energy Information Administration (EIA), crude oil production increased by 790,000 barrels per day between 2011 and 2012, the largest increase in annual output since the beginning of U.S. commercial crude oil production in 1859.[6] In 2011, U.S. petroleum product exports exceeded imports for the first time in more than 60 years. The domestic clean-burning natural gas supply is now measured in centuries.

Not only does this improvement in energy security provide officials more foreign policy options, but also it creates a dramatic opportunity to restore America's manufacturing sector as companies seek onshore operations that can benefit from inexpensive domestic energy.

However, in each of his five budgets U.S. President Barack Obama has sought the repeal of tax treatments used by the oil and gas industry. Among his targets are intangible drilling costs and percentage depletion. Despite rhetoric to the contrary by industry opponents, neither are subsidies. The U.S. Treasury does not write checks to independent producers for intangible drilling costs or percentage depletion.

Intangible drilling costs are ordinary and necessary business expenses for services and items associated with oil and natural gas production that have no salvage value such as labor, fuel, hauling, supplies, seismic work, site preparation, etc. These costs usually represent 60 to 80 percent of the cost of a well. Only independent producers may elect to deduct 100 percent of such costs in the year they occur and only on domestic production.

Despite tremendous technological improvements each well remains a high risk and capital-intensive effort which can easily cost as much as $10 million. The immediate deduction of ordinary and necessary business costs allows producers to quickly reinvest capital in the next drilling project. The average independent producer typically reinvests more than 100 percent of annual cash flow in new drilling projects. That is, he invests all his revenue and raises or borrows additional capital.

Since its inception, the U.S. Tax Code has held that necessary expenses actually paid in carrying on any business should be allowed as deductions. It would be more than highly inappropriate to repeal the ability of independent producers to deduct ordinary and necessary business expenses, it would be economically damaging.

OIPA's producers report that on average they would drill one-third fewer wells each year were they unable to deduct ordinary and necessary business expenses. This negative impact would ripple through the economy and kill tens of thousands of oil and gas jobs immediately.

A 2010 Wood Mackenzie study put the costs of such a federal policy blunder at 58,800 U.S. jobs lost, 165,000 U.S. jobs at risk by 2020, a domestic production loss of perhaps 600,000 barrel of oil equivalents per day with 5 percent of natural gas production lost in the first year, and the curtailment of $130 billion in capital expenditures over 10 years.[7] Such projections may be conservative given advances in U.S. domestic production since 2010.

Meanwhile, percentage depletion is simply the depreciation of mineral assets as they decline. All mineral resources, except inexhaustible resources such as air, are eligible for percentage depletion. Percentage depletion has been part of the U.S. Tax Code since 1926 after cost depletion of minerals proved unworkable for both the IRS and taxpayers.

Percentage depletion is available only to independent producers and America's estimated 8.5 million private royalty owners, only on domestic production, and is limited to the first 1,000 barrels per day of production. It is further limited to the net income of a property and 65 percent of a producer's net income.

Percentage depletion is especially important to marginal well operators as it helps them offset the costs of wells that produce 15 barrels of oil equivalents per day or less. On average, each U.S. marginal well produces 2.3 barrel of oil equivalents per day. Such production numbers sound inconsequential, but are not. These marginal wells are responsible for 17.8 percent of U.S. domestic oil production and 9 percent of U.S. domestic gas production.[8] There are more than 375,000 marginal oil wells and 322,000 marginal gas wells across 29 states producing more than 262 million barrels of oil and 2.1 trillion cubic feet of natural gas annually.[9]

For every $1 million directly generated by marginal well production, more than $2 million in economic activity is generated elsewhere. Each additional $1 million of marginal well production employs 10 direct and indirect workers, with some producers employing as many as 15 workers.[10]

The loss of percentage depletion would be catastrophic for marginal well producers and damaging to the national economy. Once a well is abandoned it is rarely cost-effective to bring it back on-line.

The National Stripper Well Association (NSWA) estimates that the abandonment of all marginal wells would result in an estimated loss of 292,374 jobs and more than $12.5 billion in lost earnings. [11] The United States is the only nation that produces oil and natural gas in economically significant amounts from marginal wells and they are a key component of U.S. energy security.

Unlike depreciation for a building, which may be completely depreciated yet retain a value and be sold, oil and gas wells only retain an expense once depleted. Wells must be capped and sites must be cleaned up and restored in accordance with regulations. The excess of percentage depletion over cost depletion helps marginal well operators address such costs.

As referenced, percentage depletion also is important to the nation's private royalty owners. OIPA refers the Working Group to public comments by the National Association of Royalty Owners (NARO) on this topic.

OIPA directs the Working Group to the extensive histories of these tax treatments as provided by the Independent Petroleum Association of America (IPAA) and API and the comments of the American Exploration & Production Council (AXPC) and DEPA.

Finally, OIPA wishes to call the Working Group's attention to a March 2013 Harris Interactive survey of 1,000 registered voters which finds that a majority of Americans believe Congress should not raise energy taxes. The findings include:

- 74 percent of voters agree -- Now is not the time for politicians in Washington to raise energy taxes. They should solve the country's budget issues without hurting consumers and taxpayers.
- 63 percent of voters agree -- Raising taxes only on America's oil and natural gas industry, or just on a handful of companies, as some politicians in Washington have recommended, would be bad tax policy, as well as unfair and discriminatory.
- 69 percent of voters agree -- Increasing energy taxes, like taxes on oil and natural gas companies, hurts everyone because those tax increases could drive up energy costs for consumers.
- 57 percent of voters agree -- Increasing energy taxes, like taxes on oil and natural gas companies, could kill jobs and negatively impact the economy.

# # #

[1] Independent Petroleum Association of America, 2012.
[2] "The Economic Contribution of the Onshore Independent Oil and Natural Gas Producers to the U.S. Economy," IHS Global Insight, April 2011.
[3] Ibid.
[4] Ibid.
[5] America's New Energy Future: The Unconventional Oil and Gas Revolution and the U.S. Economy, Volume 1, National Economic Contributions, IHS Global Insight, October 2012.
[6] Short-Term Energy Outlook, U.S. Energy Information Administration, February 2013.
[7] "Evaluation of Proposed Tax Changes on the U.S. Oil & Gas Industry," Wood Mackenzie, August 2010.
[8] Oklahoma Marginal Wells Commission, April 2012.
[9] National Stripper Well Association, April 2012.
[10] Ibid.
[11] Ibid.